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C O N F I D E N T I A L SECTION 01 OF 02 DAMASCUS 001696

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NEA/ELA
TREASURY FOR GLASER/SZUBIN/LEBENSON
NSC FOR ABRAMS/DORAN/SINGH
EB/ESC/TFS FOR SALOOM

E.O. 12958: DECL: 04/13/2016
TAGS: ECON EFIN EINV SY
SUBJECT: SUBSIDIES CREATING HEAVY FISCAL BURDEN

REF: A. DMS 5045

¶B. DMS 0893
¶C. DMS 1273
¶D. DMS 0716

Classified By: Charge d'Affaires Stephen Seche, reasons 1.4 b/d.

¶1. (C) Summary: The SARG spends billions of dollars on subsidies and support for inefficient State-Owned Enterprises (SOEs) that are consuming a growing portion of state revenue. The subsidies are the largest fiscal pressure on the SARG budget with oil revenues declining, and their removal represents the economic issue most capable of triggering social unrest. As a result, the SARG currently is spending down its foreign currency reserves to finance the subsidies, and contacts say that the SARG may be willing to sustain them in order to avoid increased inflation and alienating the public at a time when renewed outside pressure is still possible. End summary.

¶2. (SBU) Last month, the Syrian public widely expected an increase in diesel prices from 7 SYP/liter to 12 SYP/liter. The decrease in the diesel subsidy was part of a larger plan to gradually rationalize domestic prices on basic commodities with those of other countries in the region. The plan, which Deputy Prime Minister for Economic Affairs Abdallah Dardari announced in October 2005, was hailed by reformers in and out of government as a way to reduce pressure on the budget, abolish black market trading in commodities, and decrease the incidence of cross-border smuggling through which Syria loses an estimated 20% of its diesel supply every year (ref A). Recently, however, the SARG has begun to publicly back away from talk of subsidy reductions. Dardari stated last week that the SARG will keep subsidies intact, and that the government can sustain the diesel and other price supports for the foreseeable future.

¶3. (C) Contacts among independent Syrian economists contend, however, that Dardari's comments belie the tremendous strain that the cost of subsidies is placing on Syria's fiscal position. Contacts estimate that the SARG spends more than $6 billion annually on all subsidies and price controls, which equates to more than 60% of the $9.9 billion 2006 budget or almost 28% of GDP. The subsidy on imported diesel is the single largest subsidy, on which the SARG spent $2 billion in 2005 to keep the domestic price 23 SYP/liter below the regional price. Contacts point out that the $6 billion price tag for subsidies far exceeds the $500 million allocated for "price stabilization" in the 2006 budget.

Therefore, they state, subsidies will increase the budget deficit far above the $1.18 billion anticipated for the coming year (ref B).

¶4. (C) Besides diesel, the $6 billion includes subsidies for staples such as bread, sugar and rice, which contacts estimate may exceed $400 million in 2006. Further, the SARG spends approximately $2 billion each fiscal year to cover the operational deficits of SOEs that distribute a wide range of agricultural, energy and industrial subsidies, including an estimated $350 million subsidy for wheat exports. (Note: Syria produces wheat at a cost of $80/ton above the world price for the commodity. End note.) Most of the rest of the $6 billion worth of subsidies is spent on keeping electricity costs low. Despite the fact that the SARG has reduced subsidies and price controls on cement and some oil derivative products such as heavy fuel oil and gasoline over the past year, contacts state that those reductions have not done enough to reduce the magnitude of the subsidy load and that a reduction in the diesel subsidy is necessary to release the immediate fiscal pressure.

¶5. (C) Increased consumption of diesel is cancelling the benefit the SARG could realize from the high price of oil. Syria historically imports half of the diesel that it consumes. Diesel consumption rose 10% last year, while domestic production remained stagnant, and is expected to increase another 10% in 2006. With oil production declining by an estimated 15% per year, contacts contend that if no action is taken soon to either reduce the subsidy or increase domestic production, the SARG will not have sufficient oil revenue to cover subsidies and its rising deficits. Dardari recently was quoted as saying that 2006 will be the first year in which Syria's imports of oil derivatives equal its export of oil. Though other economists have expressed some

skepticism that Dardari's pronouncement is accurate, it does indicate how seriously the SARG views its declining oil production and revenues. Therefore, contacts say, if the SARG wishes to sustain subsidies at their current levels, it will have to assume even larger opportunity costs of lost investment and future support for the currency by spending down its accumulated hard currency reserves.

¶5. (C) Contacts report that despite the fiscal pressure of sustaining subsidies and its drain on foreign reserves, the SARG is hesitant to reduce the diesel subsidy in part because of its potential inflationary effect (ref C). Local media has been seized with the issue of price inflation in the major metropolitan areas since late 2005, with almost daily articles complaining about Syrians' eroding purchasing power. Abdulkadr Housrieh, one of the intellectual authors of the SARG's subsidy reform plan, stated that the SARG is placing more emphasis on the possible social repercussions of a diesel price increase- including the possibility of public manifestations of anger toward the regime- than on the economic repercussions of sustaining the subsidy. He lamented that the current subsidy policy effectively sacrifices the future in order to keep people happy and "asleep" in the present.

¶6. (C) Comment: The SARG is between a rock and a hard place concerning the diesel subsidy. Reducing the subsidy would create additional inflationary pressure and make it harder for ordinary Syrians to make ends meet. However, by sustaining it, the SARG faces ballooning deficits and a rapid erosion of its fiscal position. While the SARG may have enough foreign reserves to sustain its subsidies for the short term, this course would force it to scrap its ambitious development plans. Additionally, using its accumulated reserves to support subsidies would make them unavailable for use to defend its currency (ref D), leaving it vulnerable if the SARG is again subjected to intense international pressure.
SECHE